DOCKET FILE COPY ORIGINAL

TENNESSEE PUBLIC SERVICE COMMISSION
460 JAMES ROBERTSON PARKWAY
NASHVILLE, TENNESSEE 37243-0505

RECEIVED
DEC 13 1993
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

December 10, 1993

William F. Caton, Acting Secretary
Federal Communications Commission
2000 L Street, N.W.
Washington, D.C. 20554

IN RE: In the Matter of: Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates

CC Docket No. 93-251

Dear Mr. Caton:

This is to transmit comments of the Tennessee Public Service Commission staff concerning the Notice of Proposed Rulemaking released by the Federal Communications Commission in the above styled cause on October 20, 1993.

Yours truly,

Archie Hickerson
Deputy Director

cc: William A. Kehoe, III

No. of Copies rec'd Copy
List A B C D E

RECEIVED
DEC 13 1993
FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

BEFORE THE
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of: Amendment of Parts 32 and 64 of the Commission's Rules to Account for Transactions between Carriers and Their Nonregulated Affiliates	)))))	CC Docket No. 93-251

COMMENTS OF THE
TENNESSEE PUBLIC SERVICE COMMISSION STAFF

On October 20, 1993 the Federal Communications Commission (FCC) issued a Notice of Proposed Rulemaking (NPRM) inviting comments from interested parties concerning the reevaluation of the FCC's affiliate transaction rules. These affiliate transaction rules, setting forth federal accounting requirements for transactions between carriers and their unregulated affiliates, had previously been adopted in the Joint Cost proceeding. The FCC proposes to amend these rules to enhance its ability to keep carriers from imposing costs of unregulated activities on ratepayers and to keep ratepayers from being harmed by carrier imprudence.

SUMMARY OF TPSC STAFF COMMENTS

The Tennessee Public Service Commission Staff (TPSC Staff) supports the FCC's attempt to strengthen the affiliate transaction rules. The affiliate transaction rules, as originally adopted in the Joint Cost proceeding were a significant step in safeguarding regulated carriers from subsidizing nonregulated entities. However, we believe the six years that have passed since the affiliate transaction rules were first adopted have shown many areas where improvements are needed. Also, many technological and regulatory changes have occurred in the telecommunications industry since the Joint Cost proceeding was concluded which required changes in the way affiliates dealt with one another and accordingly in the accounting treatment of those transactions. We support the FCC's proposals outlined in the NPRM and offer comments on the following specifically identified changes. For clarity and ease of comparison to the NPRM, our comments are arranged and headlined in the same outline format as contained in the NPRM.

DISCUSSION

III. VALUATION METHODS

B. Tariffed Rates

We agree with the proposal to continue to price affiliate transactions at the tariff rates when tariffs are available. We propose that the definition of tariff rates be extended to include Commission approved contracts between the regulated carrier and specific customers for the provision of services not otherwise tariffed and made available to the public.

C. Prevailing Company Prices

2. Marketplace Considerations

We agree with the proposal to eliminate using prevailing company pricing when the primary purpose of the nonregulated affiliate is to provide goods and services to the regulated carrier. Since the decision by the regulated carrier to purchase services from such an affiliate is at less than arms' length, the prices paid for the assets or services are not likely to be determined using the same market considerations as a transaction with a nonaffiliated company. Furthermore, an affiliate that has the primary purpose of providing goods or services to the regulated carrier is simply an extension of the regulated carrier and should recover no more in a transaction than the amount that would be expended by the regulated carrier if it performed the operation itself. In other words, a regulated carriers' cost of service should not be increased due to a corporate decision to create a nonregulated affiliate to provide services necessary for the provision of a regulated service when the regulated carrier could provide those services itself.

One example of such an affiliate is a nonregulated real estate affiliate that charges the regulated carrier a "market" rental rate for office space which is based on rental rates charged to a third party that occupies a only very minor portion of the building in question. In this case, no "market" rate has been established and no prevailing company price is available. Since the primary purpose of the building is to provide service to the regulated carrier, the nonregulated affiliate should not be allowed to earn a greater return on the asset than if the carrier owned the building itself.

The proposed "bright line" test 75 percent sales to unrelated companies is a reasonable method to use to determine if an affiliate can use prevailing company pricing. However, our concern is that the FCC and state Commissions must have access to the books and records of the nonregulated affiliates in order to verify that the 75% test is being met and that the valuation methods are properly enforced. Therefore, we recommend that these new rules specifically require that both the FCC and the state Commissions have access to the books and records of such affiliates for verification purposes.

D. Fair Market Value

3. Services

We agree that using fully distributed cost as the only pricing method for services transferred between a carrier and its affiliates when neither a tariff nor a prevailing company price is available could promote inefficient buying and selling among the affiliates. Many of these services may in fact have a market value which would be more beneficial to the regulated carrier than simply using the fully distributed cost.

Even if the FCC did not have price cap or optional incentive regulation plans in place, the carriers should be required to make purchases in the most efficient manner. Changing the affiliate transaction rules so that the valuation for purchase of services is consistent with the purchase of assets is a step in the direction of more efficient purchasing.

There is no public interest justification for a regulated carrier to purchase assets or services from either an affiliate or a nonaffiliate at a price in excess of the fair market value. The only reason to pay an affiliate in excess of market would be to increase the profit of the nonregulated affiliate. Therefore, increasing the return to the stockholders at the expense of the ratepayers. Likewise, the only logical reason why a carrier would pay an affiliate in excess of the cost for a service is to again circumvent regulation and earn a greater return for its stockholders than would be allowed if the service were performed as part of the regulated operations. Therefore, we agree with the FCC's proposal requiring carriers to record purchases of services from an affiliate at the lower of market value or fully distributed cost when a tariff or prevailing company price is not available.

Similarly, there is no justification for a regulated carrier to sell services to an affiliate at a price below market value. If the regulated carrier does sell services below market value, it foregoes revenues that would be used to reduce the rates charged to interstate and intrastate ratepayers and is again subsidizing the affiliate at the expense of the regulated ratepayers. In addition, there is no justification for a regulated carrier to sell services below its cost. To do so would also result in the ratepayers subsidizing the nonregulated affiliate. Since the objective of the affiliate transaction rules is to protect the ratepayers from subsidizing nonregulated operations, we agree with the FCC's proposal to require the carriers to price services sold to affiliates at the higher of market value or fully distributed cost.

E. Other Valuation Method Issues

2. Other Valuation Method Issues

In general we are concerned with the use of alternative pricing methods and share the FCC's concern with allowing carriers to use the term "subsidy" to describe the pricing methodology for a transaction. This term is vague and nondescriptive. In general "subsidy" means that the regulated carrier is recovering from its affiliate more than its cost of producing the service or product. However, "subsidy" does not describe how much in excess of the cost is being recovered and it does not mean that the regulated carrier is being compensated at or near the market value of the product or service. As a result, we do not believe that "subsidy" is an acceptable description.

If an alternative methodology is to be used, it should be fully described in the Cost Allocation Manual (CAM) and allowed to be implemented only after review and approval by the

FCC. Such approval should be granted only after the state Commissions have had an opportunity to thoroughly investigate and provide comments on the proposal to the FCC. No alternative pricing methodology should be allowed unless it can be demonstrated that it is beneficial to either the regulated interstate or intrastate operations of the carrier.

An example of a problem with this "subsidy" approach is the contract between BellSouth Advertising and Publishing Corporation (BAPCO) and South Central Bell (SCB) for the publication and production of white and yellow page directories. Prior to divestiture the directory operation was included in the regulated operations of SCB and the revenue, expenses, and investment were recorded in the regulated accounts. In 1984, the directory operations, both white and yellow pages, were transferred from SCB to BAPCO and at that time the two companies signed an agreement that identified the responsibilities of each party and provided for the division of revenues. This arrangement was negotiated at less than arms length and does not adequately compensate the regulated carrier for the value of the operations that were transferred to the nonaffiliate. The contract governing this relationship, which the carrier claims provides a "subsidy" to its intrastate telephone operations, actually results in a level of revenue on the regulated carrier's Part 32 books being substantially below the amount that would be recorded by the regulated carrier if the directory operations had not been transferred to the nonregulated affiliate. Although this understatement of revenue on BellSouth's Part 32 books was estimated to be $400 million from divestiture until July, 1990, the state Commissions have fought considerable battles with BellSouth in intrastate ratesetting proceedings in order to recognize portions of this directory revenue as belonging to the regulated carrier. In this example the "subsidy" arrangement has not resulted in the desired results and has caused the revenue reported in the Part 32 income statements of the regulated operations to be materially below the amount used for setting rates. Had the state Commissions relied on the revenue recorded in the Part 32 books in accordance with this contractual arrangement for this affiliate transaction the ratepayers would have been adversely impacted by a corporate decision to transfer an operation that has historically been viewed as regulated to a nonregulated affiliate. The methodology followed by BellSouth to account for the directory transaction is an example of a procedure that does not comply with the intent of the affiliate transaction rules since it does not protect the ratepayers.

We are concerned that the acceptance of "subsidy" type pricing arrangements between the regulated carriers and its affiliates will promote additional spin-offs of the more profitable portions of the business in an attempt to protect the revenues from being considered in setting rates. While we would not dictate the corporate organization the affiliate transaction rules must be designed to provide protection to the ratepayer from being adversely impacted by any reorganizations.

Therefore, we recommend that the "subsidy" approach not be accepted and generally that transactions be priced at tariff, market value, prevailing company price or fully distributed cost as applicable. However, if a particular transaction does not meet the requirements to be priced using one of these methods, an alternative methodology should be adopted that will ensure that the intent of the affiliate transaction rules is carried out. That is, the ratepayers must not be adversely impacted due to a transaction between a regulated carrier and an affiliate. Specifically, if an operation that has traditionally been included as part of the regulated operations is transferred to a nonregulated affiliate the rates for intrastate or interstate services should not be increased. Furthermore, even if the interstate jurisdiction is not affected by the transaction (yellow pages) the FCC should require the same justification from a carrier before it is allowed to use an alternative pricing method as it would if the interstate jurisdiction were impacted.

<u>IV. IMPLEMENTATION</u>

<u>A. Costs to the Affiliate Group</u>

<u>2b. Chain Transactions</u>

Tracing the resources to provide a transaction through each affiliate and pricing the transaction at each step in accordance with the valuation methods identified in the NPRM will best protect ratepayers from cross-subsidization when transactions are chained through affiliates. We have not performed an analysis of the cost of either this proposal or the alternative.

We do point out that a very important aspect of any affiliate transaction rule is the continued cooperation of the FCC and state Commissions in reviewing such transactions for compliance with the rules. As a result, it is critical that the affiliate transaction rules provide state Commissions with access to the records of the affiliates that support any transactions in order to provide assurance that such rules are being carried out as intended.

As stated in the NPRM, "...this Commission has subjected neither the connecting carriers nor nonregulated affiliates to other portions of the USOA. To ensure that the costing process is based on reliable data, we propose that, except as otherwise ordered by this Commission, all accounting related to affiliate transactions must comply with generally accepted accounting principles (GAAP)." We are concerned with one aspect of this approach. That is, the failure of affiliates to follow Part 32 accounting procedures to identify costs billed to regulated carriers in accordance with the Part 32 expense matrix that classifies expenses as "Salaries and Wages", "Benefits", "Rents", and "Other". This has caused distortions and reduced the usefulness of the accounting records. An example is the merger of BellSouth Services, Southern Bell, and South Central Bell into BellSouth Telecommunications. Prior to the merger, the costs billed from BellSouth Services to the regulated carrier were recorded in the "Other" category of the Part 32 expense matrix. Once the merger occurred these costs were classified as "Salary and Wages", "Benefits", "Rents", and "Other" as applicable. As a result, the information in the matrix after the merger is not comparable to the matrix before the merger. This incomparability has caused the expense matrix, which was very useful tool in analyzing changes in cost, to lose its' usefulness. Therefore, we recommend that when affiliates bill the regulated carrier using the fully distributed cost methodology that the cost be provided and recorded in the expense matrix format unless the carriers and the affiliates can show that due to the nature of the services provided that the bill cannot be broken down into this format.

3c. Return Component

We believe the return component carriers include in affiliate transaction costs should continue to be limited and should be based on a weighted average of the interstate and intrastate returns granted to the regulated carrier.

Because of the many new regulatory methodologies in use today, such as price caps and incentive regulation plans, we propose that the FCC adopt as simple a method as possible to provide a reasonable rate of return on the affiliate transactions. We propose that the return be a weighted average of the rates of return allowed in each of the state jurisdictions and the Federal interstate return. The weighting could be based on the net investment assigned to the Federal and individual state jurisdictions.

We believe it is imperative that the FCC consider the intrastate rates of return since the majority of the states have adopted these affiliate transaction rules and rely on them to provide an accurate measurement of the intrastate cost of service. We do not believe this improperly delegates FCC authority to the states, but instead continues the cooperative efforts needed between the FCC and the state Commissions in todays telecommunication environment.

Furthermore, we propose that a statement of the rate of return be included in the CAM and be subject to the same filing requirements as any other change to the CAM.

B. Prevailing Company Prices

1. 75 Percent Test

We believe the first of the two alternatives presented in the NPRM for determining if an affiliate meets the 75 percent test is more desirable.

The first alternative is more desirable since the carrier is responsible for projecting how transactions with its affiliates for the coming year will be priced. This will give the FCC and states more easily attainable access to information used in making the determination. This alternative also allows for year end true-ups should the projected sales by the affiliates to nonaffiliates not meet the initial projections.

Our concern about the first alternative is that year end true-ups may become cumbersome and complicated. For instance, how will carriers restate purchases that occurred during the year from an incorrectly applied prevailing company price to a fair market value? Furthermore, we are concerned that information on the affiliates' sales must be available for audit and verification by the FCC and state Commissions if these valuation rules are to be enforced.

These concerns can be overcome by requiring the carrier to maintain all supporting documentation used in making projections of the affiliates usage and making the books of the affiliates available for audit by the FCC and state Commissions.

The second method is less desirable because basing future affiliate sales on past performance without true-ups at year end presents the possibility that accounting records will be incorrect since the transactions had been priced incorrectly during the year. We believe it is critical that Part 32 accounting records reflect properly priced affiliate transactions. This may not occur if year end true-ups are not required.

2. <u>Other Potential Conditions</u>

We believe applying the 75 percent test using a product line approach is most appropriate since it segments the affiliates' operation into more exacting categories. Since product lines will be sold in varying degrees to affiliates and nonaffiliates, a more accurate determination of whether the 75 percent test is met can be made. This approach will minimize the impact that sales of other products will influence whether or not the 75 percent test is met.

We believe the line of business approach is less desirable since it will not be as accurate as the product line in determining if the 75 percent test is met. This is because making the 75 percent test on a total line of business basis may indicate an improper level of sales to either affiliates or nonaffiliates due to the sales pattern of an individual product line. This improper result would cause the other product lines within the line of business to be incorrectly priced.

While applying the 75 percent test on a product by product basis is the most accurate measurement we believe it is inappropriate since it will be burdensome to carriers considering the vast number of products they offer.

We do not believe the 75 percent test should be adopted on a total company basis since it is the least accurate of the methods proposed. Again, this is because variations in sales among either product lines or lines of business between regulated carriers and nonaffiliates could give misleading results and allow incorrect valuation of transactions.

C. Fair Market Value

We agree that defining specific steps for determining the fair market value of each nontariffed affiliate transaction for which prevailing company pricing is not permitted is not appropriate. This would be burdensome and would not allow consideration of variations in transactions that would require that different steps be taken to determine fair market value.

However, we are concerned that giving carriers the responsibility to make a good faith estimate of the fair market value without enacting some requirements of documentation and audit trails will make it difficult if not impossible for the FCC and state Commissions to determine if the carrier made the correct decision on pricing the transaction. We are also concerned as to what constitutes a good faith effort.

Therefore, we believe the FCC's rules should include minimum requirements such as those identified in the NPRM (obtaining competitive bids, surveying suppliers or getting independent appraisals) that must be met by the carriers in determining a fair market value. The FCC's rules should also include minimum requirements carriers must meet in retaining documentation of its efforts to determine fair market value and requiring audit trails of this process.

CONCLUSION

In summary, we support the FCC's attempts to strengthen the affiliate transaction rules as adopted in the **Joint Cost** proceeding and request that the recommendations contained in our comments be adopted by the FCC to further strengthen and clarify the new valuation rules presented in the NPRM.

Respectfully submitted,

Archie R. Hickerson
Deputy Director